

CHAPTER I

BOARDS OF DIRECTORS HAVE FAILED AND WE DON'T KNOW WHY



Directors are like parsley on fish—decorative but useless.

—Irving Olds, former Chair, Bethlehem Steel

The director walks a tightrope. His responsibility is to be supportive to management, but not a rubber stamp. He directs, but he does not manage. Legally he has the ultimate responsibility for both the formulation of strategy and its implementation, but as a practical matter he relies on the CEO. He and his fellow directors elected the CEO, but he may later have to remove him. He is responsible for the long-run health of the corporation but most of the information he receives on its performance relates to the short run. He has a legal responsibility to the shareholders, but he has a moral responsibility to the employees, customers, vendors and society as a whole. He is responsible for keeping the shareholders informed, but at the same time he should not disclose information that would be adverse to the company's best interests. He has personal goals, as does the CEO. However, the director must ensure that neither his goals nor those of the CEO overshadow their obligations to the corporation and its goals.

—Charles A. Anderson and Robert N. Anthony,
in *The New Corporate Director*

It was the best of times; it was the worst of times.

—Charles Dickens in *A Tale of Two Cities*

Few people buy shares in a company for the sake of buying shares. Rather they become shareholders in the expectation that the value of their shares will increase—that they will make money. When they entrust the use of their funds to the corporation, a legal entity governed by a board of directors, it is an act of trust on their part that the board will make decisions that will not only conserve their capital but also increase it. And, by taking it, a board of directors is committing itself to accepting the responsibility of using other people’s money in an intelligent, prudent, honest and successful manner.

Nothing is more important to the well-being of a corporation than its board of directors. The board, by law, has the responsibility for the overall performance of the business. It has the power to appoint the management of the enterprise, to delegate to it specific responsibilities and to oversee the strategic direction and the setting of long-term goals for the company. It is a self-governing body that has the power, within very few limits, to manage its own affairs. In short, the board, by law, is the *decision-making* body of the corporation. To the extent that the directors acting collectively as a board make wise decisions, the corporation will prosper; to the extent that the board does not, the corporation will stagnate or fail. Consequently, knowing how and why boards make decisions is fundamental to an understanding of why some corporations succeed and others do not.

And yet, in spite of the importance of board decision-making in the life and death of companies, little is known about how boards work. Almost nothing is known about the decision-making characteristics of individual board members, and even less is known about the manner in which individuals act together to arrive at board decisions, either in a crisis or in the normal course of business activity. In short, almost nothing is known about arguably the most important function of boards of directors—the way in which they make decisions.

IGNORANCE ISN’T BLISS

There are many reasons why companies succeed. Sometimes it is because the board of directors has selected extraordinarily good management; sometimes it is because of a technological advantage;

sometimes it is because of extraordinary timing in the production of a particular product.

Similarly, there are many reasons why companies fail. Sometimes it is because of exogenous events that the board of directors did not foresee and over which they had no control. Occasionally it is because the board is badly advised or there is fraud that they don't know about.¹ More often it is because they do not always insist on and/or participate in the development of effective strategies and astute activities that increase shareholder value. Indeed, unfortunately, many times it is because the board does not always effectively monitor the management of the enterprise, with the result that the owners lose money. And, all too often, a board monitors the activities of a company so poorly that the shareholders lose all their investment.

Boards of directors are not made up of stupid people. To the contrary, they often have as their members some of the brightest and best members of the community—men and women who have proven their capabilities in a variety of activities. Moreover, the tasks that directors are expected to perform are not only well-known, but under normal conditions are not overly onerous. And the motivation for directors to do well is great. Certainly no one joins a board of directors to help a company fail, or indeed does when the prospects of failure are expected to be substantial. Just the opposite: people join boards to assist in guiding an enterprise to success. And yet some boards make poor decisions that lead to disaster, whereas others make good decisions that lead to success.

But why is this so? Why do some boards choose brilliant chief executive officers while others do not? Why do some pick strategies that prove effective while others never seem to get things right? Why do some seem exceptionally able to calculate the risk involved in mergers and the advantages to be found in divestitures, whereas others engage in merger activities that never turn out well? Why do some boards seem continually to make wise decisions that lead to above average returns for the shareholders, whereas others never seem to be able to make any money?

1. It should be noted that by law directors are not responsible for business decisions that in the fullness of time turn out to be incorrect, if, at the time they made the decision, they exercised proper business judgment.

ASKING THE RIGHT QUESTIONS

Unfortunately, no one knows the answer to the most important question about corporate governance—“How do boards of directors make decisions?” No one knows the factors that lead to good or bad decision-making. No one knows how directors work together to decide what should be done in the best interest of the corporation. No one knows the factors that lead to good decision-making by a board when good decisions are identified as improving shareholders’ value and stakeholders’ interests. And, most importantly, no one knows how boards should be selected to assure that their decision-making capabilities are maximized. In short, no one knows the characteristics of an effective board.

It is the thesis of this book that board decision-making is a function of the competencies and behavioural characteristics of individual directors and how they fit together. It is argued that improvement in board operations will not be achieved, as is so often contended, by the enactment of more regulations and laws governing the structure of boards; rather that it will come through the willingness of directors, managers, regulators, shareholders and corporate leaders to accept new and different, somewhat radical, criteria for the selection, appointment and evaluation of directors.

Coming out of the trials and tribulations associated with corporate governance during the first years of this century is evidence to support the proposition that there *is momentum* to adopt new approaches to the creation of boards. Whether the momentum is sufficient to bring about a true revolution in corporate governance in the twenty-first century depends, in the final analysis, on the number of “change agents” there are among directors and corporate leaders who are willing to make major changes in their own organizations—corporate boards.

THE “SUMMER OF FRAUD”

The early years of this century have not been a period of particular pleasure for North American corporations and the people responsible for their regulation and governance. To the contrary, it has been one

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of the most devastating periods in the modern history of corporate capitalism. Corporate malfeasance and individual scandals have rocked the capital markets and destroyed investors' confidence and faith in many of the institutions that are fundamental to making the capitalist market system work. During the two-month period from May to June of 2002, referred to as the "summer of fraud" by James B. Comey, Deputy Attorney General of the United States,² the headings of major stories in the leading business magazines told the story.

Table 1.1

Headlines of Major Stories in Leading Business Magazines, May–June, 2002
<ul style="list-style-type: none">• "Special Report: The Crisis in Corporate Governance," <i>Business Week</i>, May 6, 2002.• "How Corrupt Is Wall Street?" <i>Business Week</i>, May 13, 2002, 37.• "Trouble in the Boardroom," <i>Fortune</i>, May 13, 2002, 113.• "Enron's Demise Has Taken the Shine Off the Boardroom Table," <i>Financial Times</i>, May 30, 2002, 14.• "Tyco Board Is Criticized for Kozlowski Dealings," <i>Wall Street Journal</i>, June 7, 2002, A5.• "The Wickedness of Wall Street," <i>The Economist</i>, June 8, 2002, 11.• "SEC Wants CEOs, CFOs to Vouch For Reports, Disclose More, Sooner," <i>Investor's Business Daily</i>, June 13, 2002, A1.• "Under the Board Talk: American Companies Need Stronger Independent Directors," <i>The Economist</i>, June 15, 2002, 13–14.• "Designed by Committee: How Can Company Boards Be Given More Spine?" Special Report on Corporate Governance, <i>The Economist</i>, June 15, 2002, 69.• "The SEC's Accounting Reforms Won't Answer Investors' Prayers ... But Changes in the Boardroom Could Rebuild Trust," <i>Business Week</i>, June 17, 2002, 28–29.• "When Directors Join CEOs at the Trough," <i>Business Week</i>, June 17, 2002, 57.• "Venal Sins: Why the Bad Guys of the Boardroom Emerged en Masse," <i>Wall Street Journal</i>, June 20, 2002, A1.• "Restoring Trust in Corporate America: Business Must Lead the Way to Real Reform," <i>Business Week</i>, June 24, 2002, 31.

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2. Luncheon address: "Lessons Learned from Recent Corporate Debacles," 2004 Annual Corporate Governance Conference, National Association of Corporate Directors, Washington, DC, October 18, 2004.

- “System Failure: Corporate America, We Have a Crisis: 7 Ways to Restore Investor Confidence,” *Fortune*, June 24, 2002, 62–77.
- “WorldCom’s Travails Could Affect Its Directors,” *Wall Street Journal*, June 28, 2002, A9.

In a chart entitled “A Question of Accountability,” *The New York Times*³ listed examples of major American companies where there were “auditing lapses,” “the hiding of loans or losses,” “insider trading” and “inflating revenue.” It reads like a Who’s Who of North American business—Arthur Andersen, Deloitte & Touche, Ernst & Young, KPMG, PricewaterhouseCoopers, Adelphia Communications, Enron, Kmart, PNC Financial Services Group, Tyco International, WorldCom, ImClone Systems, Computer Associates International, CMS Energy, Dynegy, Edison Schools, Global Crossing, Halliburton, Lucent Technologies, Network Associates, Qwest Communications International, Reliant Resources, Trump Hotels and Casino, Waste Management and Xerox. Canadian examples of corporate failures and scandals include Livent, BreX, YBM Magnex, Philips and, most recently, Hollinger.

And is there anyone who has not heard of the stock market adventures of Martha Stewart? And that some leading executives have gone to jail for fraudulent practices?

Even in the heady days of the “takeover movement” in the early 1990s, when such high-powered players as Ross Johnson and Michael Milken were in the headlines, there was never such attention paid to the corporate community and the organizations with which it is associated—investment bankers, accountants, lawyers, brokers, commercial banks and investment advisers.

By any definition, the attacks and reports have not been undeserved. The damages and losses to corporate stakeholders resulting from the above failures and abuses were widespread and incredibly damaging. Retirees, employees, shareholders, bondholders, creditors and suppliers lost upwards of tens of millions and in some cases

3. June 16, 2002, BU 12.

billions of dollars as a consequence of mismanagement, accounting fraud, false reporting and totally misleading, if not downright dishonest, investment advice. The investments and pension plans of literally thousands of individuals and families were “wiped out” or essentially rendered worthless as a result of the breakdown in the institutions of capitalism. Given these scandals, it is not astonishing that the confidence the public once had in the fairness and honesty of the economic system has been significantly eroded. Nor is it surprising in the wake of such activities that, in the early years of this century, the American public began to be less willing to invest in much lauded American companies to the extent they had in the late 1990s.

CORPORATE ACCOUNTABILITY GOES CENTRE STAGE

Naturally, as the concern for “corporate accountability” gave way to questions about “corporate responsibility” and finally “corporate corruption,” there was strong political reaction. In July 2002, the President of the United States, George W. Bush, delivered a major speech—a speech billed as important as a State of the Union address—on corporate responsibility. In this address, he outlined proposals for imposing strict discipline and punishment on corporate wrongdoers, and reiterated his administration’s support for corporate governance reforms. He pledged a strengthening of the Securities and Exchange Commission (SEC) and endorsed the new listing proposals being advanced by the New York Stock Exchange (NYSE). Not to be outdone, in the same month, the United States House of Representatives and the United States Senate overwhelmingly passed H.R. 3763. Widely known as the “Sarbanes-Oxley Act of 2002,” this legislation called for broad new regulations, described as the most far-reaching in over seventy years, affecting issuers of publicly traded securities, corporate directors and independent advisers such as auditors and lawyers. The Act was signed by the President and enacted into law on July 30, 2002.

Unfortunately, no one knows whether the Sarbanes-Oxley legislation will do much to improve corporate governance in America, other than increase the costs of operating governments and corporations.

According to law, the major responsibility for the operations of corporations lies with the board of directors, and the plethora of new regulations are designed to impact boards' operations, even though no one knows very much about how boards of directors work.

For the first seventy-five years or so of the twentieth century, despite the fact that boards of directors had the responsibility for the actions of the corporation, the conventional wisdom was that boards of directors actually did not have much impact on corporate operations. In fact, as long ago as 1932, Adolph Berle and Gardiner Means claimed in their book *The Modern Corporation and Private Property*⁴ that the amount and spread of share ownership of the American corporation had become so great that owners no longer controlled the organizations that they owned.

It was not news that, as a result of the rise of American capitalism and the spread of share ownership, the vast majority of the owners of the modern corporation had little to do with the actual management of the companies that they owned. But what was new and absolutely startling in Berle and Means' book was the assertion that boards of directors no longer represented the interests of the owners, if they ever did, but rather they had become nothing more than the handmaidens of the managers of enterprises, *i.e.*, that there was a real separation between control and ownership. This was truly revolutionary thinking because, by law, directors were elected by the shareholders and paid to represent their interests. They were responsible for overseeing the well-being of the enterprise, including the appointment and firing of senior management, selecting strategies and protecting the investments of the owners. To the extent that they failed to fulfill these duties in a proper fashion, the shareholders could sue them, and occasionally they did.

LEGALLY POWERFUL, BUT NOT REALISTICALLY POWERFUL

As usual, the conventional wisdom was correct. While by law the directors had all the power, directors exerted practically none. Their

4. Adolph Berle and Gardiner Means, *The Modern Corporation and Private Property* (Buffalo, New York: Macmillan and Company, 1933).

nomination and election was dictated by management, with the result that boards were controlled by management instead of the other way around. And since management controlled the directors, management was able to run the organization in its own interest, rather than the shareholders'.

Consequently, Olds' characterization of directors being "like parsley on fish—decorative but useless," while somewhat exaggerated was basically true. The men (and sometimes women) directors showed up three or four times a year at the headquarters of the corporation an hour or so before lunch to sign the financial statements, exchange friendly banter and smoke cigars, and then headed out for a good golf game. Even though they were legally responsible for monitoring the enterprise, they really had nothing to do with the operations of the company.

BOARDS HISTORICALLY WERE PAID LITTLE ATTENTION

Given this reality, it is not astonishing that for at least half a century—from the end of World War II until the mid-1980s—little attention was paid to the role of the board in the governing of the corporation, or indeed to any aspect of corporate governance. General business histories of the period seldom mentioned boards. For example, Michael Bliss' *Northern Enterprise: Five Centuries of Canadian Business*,⁵ considered by some to be the most exhaustive history of Canadian business ever written, does not even list boards of directors in the index.

Perhaps even more striking is that, for nearly half a century, management scholars paid almost no attention to boards and directors. In fact the term "corporate governance" was not even used until well into the 1980s.⁶ Management texts and courses devoted almost no time to the study of boards. Koontz and O'Donnell's *Management* (1980)⁷ one of, if not the best-selling of the texts in

5. Michael Bliss, *Northern Enterprise: Five Centuries of Canadian Business* (Toronto: McClelland and Stewart, 1987).

6. Robert Tricker, *The Pocket Director* (London: The Economist and Profile Books, 1993). The first book with the title *Corporate Governance* was published in 1984 and the academic journal, *Corporate Governance: An International Review*, began publishing in 1993.

7. Harold Koontz, Cyril O'Donnell, and Heinz Wehrich, *Management*, 7th ed. (New York: McGraw-Hill, 1980).

general management in the post—World War II period, had only a few pages on the role of the board. And it is not astonishing that perhaps the most important scholar in strategy and management writing during the period, Alfred Chandler, in his great classics *Strategy and Structure: Chapters in the History of the Industrial Enterprise*⁸ and *The Visible Hand: The Managerial Revolution in American Business*,⁹ focuses on the role of management and gives little importance to the role of boards, providing further confirmation that boards were essentially unimportant factors in the governing of most corporations.

Boards, of course, were not totally dismissed. In 1971, Miles Mace of the Harvard Business School published *Directors: Myth and Reality*,¹⁰ in which he generally agreed that boards did not do much and there were occasional articles about the role of boards, but by and large they were more or less ignored through the first three-quarters of the twentieth century by scholars, chief executive officers and everyone else interested in business. They were basically treated as something that the law required incorporated organizations to have—something not of any real consequence and about which very little was known. In the first three-quarters of the twentieth century, boards of directors played a very limited role in monitoring and assisting the management of the corporation, despite the law.

Given that so much of today's regulations and codes are directed at improving governance through "improving the board of directors," the significant questions with respect to corporate governance now have to be: "Has the role of the board of directors changed dramatically in the past quarter of a century?"; "Do directors have any, let alone a major, impact on the way in which corporations are governed?"; and "Do directors exercise the power they legally have?" If the answer to these questions is "yes," then concentrating on regulating and reforming boards makes considerable

8. Alfred Chandler, *Strategy and Structure: Chapters in the History of the Industrial Enterprise* (Cambridge, Mass.: MIT Press, 1962).

9. Alfred Chandler, *The Visible Hand: The Managerial Revolution in American Business* (Cambridge, Mass.: Kelknap Press, 1988).

10. Miles Mace, *Directors: Myth and Reality* (Boston, Mass: Division of Research, Harvard Business School, 1971).

sense. But if the answer is no, then it is not likely that governance will improve markedly.

INTEREST INCREASES IN BOARD ACTIVITIES

Before the very serious problems in governance developed in the early years of this century, the conventional view was that, for a number of reasons, the not-terribly-important role of the board in the governance of enterprises was at least increasing, and that, by-and-large, directors were beginning to exercise considerably more influence on the governance of the corporations of which they were directors.

MERGERS AND ACQUISITIONS

One of the most important phenomena leading to the increasing role of boards in corporations' activities (and giving boards a good deal of publicity) was the beginning in the mid-1980s of the unfriendly takeovers movement. Traditionally, mergers and acquisitions among companies were usually, at least on the surface, relatively friendly, but by the mid-1980s, with the development of junk bond financing and other financial schemes, there were few major publicly-held companies that did not have a controlling shareholder that were safe from, or uninvolved in, a takeover bid. In order to protect what many managers felt was "their company" from an unfriendly takeover bid, many managements recommended to their boards that they put in place "a poison pill," otherwise known as a shareholder rights plan, or some other restriction designed to make it more difficult for takeover offers to be made, let alone succeed.

Historically, when change of control of companies took place, it was usually done, at least publicly, in a friendly manner. The chief executive officers would get together and work out the terms of the deal, then present them to their boards, which usually automatically endorsed the arrangement and recommended to the shareholders that they approve the transaction. It was all very straightforward, with a few major law firms and investment houses providing the professional services necessary to get the deals completed. Indeed, from the 1930s until the 1980s, no prestigious corporation would get involved in an unfriendly takeover and, if

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some extraordinarily ambitious chief executive officer tried to mount an attack on a rival corporation, it is doubtful that any of the outstanding law or investment firms would support him. It was all very polite.

In the 1980s, this rather cozy situation changed as unfriendly takeovers became very common. Some of the largest companies in the United States and Canada either became the object of an unfriendly takeover, or conversely tried, and often succeeded, in taking over an enterprise that simply did not want to merge with them. Seagram's, Dupont, Mobile Oil, United States Steel, Hiram Walker and Occidental Petroleum, to mention only a few, were all involved in transactions where control was gained or lost. The battles were often quite fierce and the rewards and losses extremely high.

If corporate boards did decide to grant approval for so-called poison pills, as many boards did, in order to deter or prevent takeovers, boards had to be careful that they did not do anything that might make it more difficult for shareholders to maximize the value of their shares in the future. To the extent that they did, they were not fulfilling their fiduciary responsibilities to the shareholders to maximize shareholder value over time. In the case of a takeover threat, boards normally hire their own professional advisers, lawyers and investment bankers—and, if there is more than one bidder, try to arrange an auction so that the highest possible price is obtained for the shareholders. The board does all these things independent of the management, because these matters are the board's responsibilities, not management's.

When a company is faced with an unwanted takeover bid, shareholders look (and still do) to the board to determine whether the company should be sold and whether the price offered is appropriate. If the directors decide that the company should not be sold to the “raider,” they may put in place various defensive efforts that can involve selling off particular assets or finding alternative, more suitable, buyers for the company. Then and now, the board must decide what to recommend to the shareholders—to accept the bid or to fight it—because, by law, only the shareholders can sell the company. Giving a recommendation is not easy, since management often was, and usually still is, opposed to a change in control, if for no other reason than they want to protect their jobs.

INSTITUTIONAL INVESTORS

Another significant reason for the increased interest in boards of directors was the increasing importance of institutional investors, primarily mutual and pension funds, in the marketplace. Historically, the funds paid little attention to the governance of corporations. However, as they became larger and began holding an ever increasing percentage of shares in various companies, it became more difficult for them to divest of shares if they were unhappy with a company's current or expected future performance, without causing a serious deterioration in share prices. For a variety of "conflict of interest" problems, they are not able to have direct representation on boards, but, because of their large shareholdings, they are able to bring pressure on corporations with respect to various governance matters. It has become the practice of organizations such as the California Public Employees' Retirement System (CalPERS) to take positions with respect to who should be on boards, by withholding their vote for directors recommended by management when they believe that such directors are not properly fulfilling their duties. The message they sent and are sending is clear: directors have to be real directors or their election will not be supported.

And the threat has not been an idle one. General Motors, Xerox, Kodak, Westinghouse, Disney and many other major American corporations have been influenced in director selection and other matters of governance by the position taken by large institutional investors. Needless to say, nominating committees are much more careful in selecting candidates for a board position, and current directors are much more conscious of their performance when they know they are being assessed by very powerful shareholders.

DIRECTORS' LEGAL LIABILITY

Moreover, the possibility of a lawsuit because of failure to fulfill one's duty of care and loyalty to the corporation has increased immensely during the past two decades. In their own interest, directors have had to take a more active role in the affairs of the corporation. While directors are protected by the business judgment rule and cannot be successfully sued for making a business mistake, if they use the rule as

a defence they must, ever since the famous *Van Gorkom* case in the United States, demonstrate that they did in fact use their informed business judgment when they made the decision that is being questioned.¹¹ In addition, in recent years there has been a great increase in the statutory obligations of directors. Directors must be concerned about their personal financial obligations for possible unpaid wages if a corporation becomes bankrupt; about certain environmental damages that may result from actions of the company; about unpaid taxes; and about unpaid contributions to pension, unemployment and social security funds. The risks of not being a vigilant and responsible director are very much higher now than they were in the 1970s.

PRESSURE FOR EFFICIENT, EFFECTIVE OPERATIONS

Finally, there have also been enormous positive reasons to expect major enterprises to be governed more effectively. During the past quarter of a century, because of the progress in the transmission of information, the increase in the speed of transportation and the elimination of many tariffs, the market for almost every good and service has become worldwide. For most companies this has meant a substantial increase in competition. No longer can firms be content to be the low-cost producers in their local market. They have to be the low-cost producers in the world. If they are not, someone will come and take their domestic market share away from them. Modern firms need modern strategies or they will not survive.

The clever chief executive officer and wise board of directors know this. As a result, they are constantly looking for directors who can help them evolve the optimum competitive policies for their firm. They do not want, and cannot survive, with a board composed of members who have no interest in the company and bring nothing to the table to make it operate better in the interests of all its stakeholders. Competition is a driving force in increasing the importance of boards and the quality of directors in modern corporations.

As a result, at the beginning of the twenty-first century it was broadly believed that corporate governance in general was better

11. *Smith v. Van Gorkom*, 488 A. (2d) 858 (Del. 1985).

understood and much improved, and that regulations governing various aspects of corporate activity were becoming more effective—that, in general, all was relatively well in the corporate world as directors went about their task of maximizing values for shareholders, and the economy and stock market both set new records in levels of activity.

THE “CORPORATE GOVERNANCE BUBBLE” BURSTS

Unlike in the period from 1930 to 1980, when boards, directors and the concept of corporate governance were generally ignored, one of the consequences of the takeovers movement, the growth of institutional investors, *etc.*, has been that the study, analysis and popularization of the corporation has increased tremendously. Biographies and autobiographies of top corporate executives such as Jack Welch of General Electric¹² and Thomas Watson¹³ of IBM headed the bestseller lists. Participants in takeover battles became famous. *Barbarians at the Gate*,¹⁴ by Bryan Burrough and John Helyar, chronicling the battle for control of RJR Nabisco, was on the *New York Times*' bestseller list for months and eventually was made into a movie for television. Connie Bruck's *The Predators' Ball*¹⁵ provides a highly entertaining account of several takeovers, with great emphasis given to the part played by Michael Milken. Newly minted investment firms like Drexel Burnham Lambert and law firms such as Skadden Arps became noted for advising on takeovers.

Not astonishingly, at the same time, a number of academic studies and articles on corporate governance began to appear. Gillies,¹⁶ Leighton and Thain¹⁷ and Dimma¹⁸ used a wealth of personal experience as the basis of their writing, while Lorsch, author of probably the most popular of all the texts on the subject, *Pawns or Potentates*,¹⁹

12. Jack Welch and John A. Byrne, *Jack: Straight From the Gut* (New York: Warner Business Books, 2001).

13. Thomas Watson, *Father, Son and Company* (New York: Bantam Books, 1990).

14. Bryan Burroughs and John Helyar, *Barbarians at the Gate: The Fall of RJR Nabisco* (New York: Harper and Row: 1990).

15. Connie Bruck, *The Predator's Ball* (New York: The American Lawyer/Simon and Schuster, 1988).

16. James Gillies, *Boardroom Renaissance: Power, Morality and Performance in the Modern Corporation* (Toronto: McGraw-Hill Ryerson Ltd., 1992).

17. D. S. R. Leighton and D. H. Thain, *Making Boards Work: What Directors Must Do to Make Canadian Boards Effective* (Toronto: McGraw-Hill Ryerson, 1997).

18. W. A. Dimma, *Excellence in the Boardroom: Best Practices in Corporate Directorship* (Toronto: Wiley, 2002).

19. J. W. Lorsch and E. MacIvar, *Pawns or Potentates: The Reality of America's Corporate Boards* (Boston: Harvard Business School Press, 1989).

based his work on interviews with nearly one hundred directors. Literally hundreds of articles on corporate governance appeared in the business journals and popular press. All had the underlying theme that governance was improving and boards were getting better—that directors were more conscious of their responsibilities to their stakeholders, and particularly to shareholders, the owners of the enterprises. And the slogan “maximizing shareholder value” became the theme of everyone associated with corporate governance.

And yet, despite all the work and analysis, and all the reports and commissions, little was learned during the period about how boards actually work. Numerous kinds of assumptions were made about corporate governance, and on the basis of these unproven assumptions, regulations and laws were passed that impacted directly on the structure and activities of boards of directors.

In short, during the last decade of the twentieth century, just as there was a “stock market bubble” and a “new technology bubble,” there was a bubble in “corporate governance analysis.” This bubble, based on few facts, suggested that, in spite of problems here and there, corporate governance in general had improved, new and significant regulations had been put in place that ensured that it would improve even more, and all was well for stakeholders in major widely-held public corporations. It, like the first two bubbles, also burst.

CRISIS MANAGEMENT LEADS TO NEW REGULATIONS

There were two major results of the extensive attention paid to corporate governance in the 1990s. First, it was increasingly believed, at least by academics, that the role of the board of directors, if any, implicitly if not explicitly, was really important only when a company was in crisis.²⁰ It was assumed that, as long as things were going reasonably well, there really was no significant function for the board to play. As a result, the focus on corporate governance from the point of view of the internal management of the firm was more on crisis

20. Savan Chatterjee and Jeffrey S. Harrison, “Corporate Governance” in Michael A. Hitt, R. Edward Freeman and Jeffrey S. Harrison, eds., *The Blackwell Handbook of Strategic Management* (Oxford: Blackwell Publishers, 2001), Chapter 19.

management than on the positive, traditional tasks associated with the board working with and monitoring management to increase the value of the enterprise on behalf of the shareholders. Second, it was generally accepted that in a capitalist system with free markets, the failure of major firms was still quite understandable and acceptable, as long as the failures were the result of market forces, but quite unacceptable if they resulted from 1) inadequacies in the institutional and legal framework within which corporations operated or 2) fraudulent behaviour on the part of the enterprises' management.

As a result of the emphasis on crisis management, which largely centred on how boards should act in the face of takeovers, a series of laws and regulations were developed that outlined acceptable procedures for dealing with such situations. Eventually it became accepted that a takeover crisis was best managed through the appointment of a special committee of the board, with the power to retain its own advisers, who, if it were decided to sell the company, would arrange to do so to the highest bidder through an auction process. While there was a modest amount of legislation associated with the crisis aspects of corporate governance, the evolution of the handling of crises was basically driven more by corporate law than by the tenets of corporate governance.²¹

Such was not the case with respect to dealing with corporate failures and perceived corporate abuses. These were dealt with through public policy and, in country after country, codes of conduct for boards were written and either enacted into law or made a condition for a company to be registered on a major exchange. In Great Britain, a committee chaired by Sir Adrian Cadbury prepared a report on appropriate corporate governance.²² It was followed by similar committees chaired by James Treadway²³ in the U.S. and by Peter Dey²⁴ in Canada.

21. See various securities acts with reference to takeover bids and issuer bids, e.g., Part XX of the *Ontario Securities Act*.

22. A. Cadbury, "Highlights of the Proposals of the Committee on Financial Aspects of Corporate Governance" in D. D. Prentice and P. R. J. Holland, eds., *Contemporary Issues in Corporate Governance* (Oxford: Clarendon Press, 1993).

23. The Committee of Sponsoring Organizations (COSO), "The Report of the National Commission on Fraudulent Financial Reporting," otherwise known as the "Treadway Report," after the Chairman of the Commission, former SEC Commissioner, James C. Treadway, October 1987.

24. The Toronto Stock Exchange Committee on Corporate Governance in Canada, "Report: 'Where Were the Directors?' Guidelines for Improved Corporate Governance in Canada," otherwise known as "The Dey Report" (Toronto: Toronto Stock Exchange, December, 1994).

All the reports, not unexpectedly and correctly, focused on the board of directors, for after all it is the board that makes the decisions that determine how the corporation functions. The underlying assumption of all codes, regulations and reports was that, if a company fails, it was basically because of poor decision-making by the board. Consequently, it was argued quite correctly that it follows that, if board decision-making were improved, corporate performance would improve. The question was, therefore, how to improve board decision-making. All the major reports emphasized that regulating the structure of the board could best do it. By this they meant, to one degree or another, that

- it was essential that directors be independent from management and that the majority come from outside the firm;
- the position of the chair of the board and the chief executive officer of the company be held by different people;
- the board be organized into committees to fulfill certain functions such as nominating new directors;
- where it was not already required by law, an audit committee composed of a majority of independent directors be formed.

Basically, the recommended changes in the form and structure of boards were made on the assumption that such changes would lead to better corporate governance through better decision-making by the board in performing its responsibilities in monitoring the activities of the corporation. They were not in any way developed to ensure that the corporation would be better able, through a different board structure, to earn a higher rate of return for the shareholders. It was clearly assumed, if it were thought of at all, that improved internal monitoring of the activities of the corporation should improve the performance of the firm, on the simple assumption that if activities are not monitored effectively, the firm may well fail.

So, the important questions about corporate governance, arising from the rash of regulations and law impinging on the structure of the board are:

1. Have all the new regulations providing for more effective monitoring of corporations by the board of directors resulted in fewer board failures?
2. Have the new regulations had any impact on the performance of corporations?

The answer to the first question is, nobody knows.

It is impossible to prove the negative. Without the increased regulations designed primarily to prevent conflicts of interest and to maintain a balance of real power between the board and management, there may well have been much more malfeasance in the operation of companies. Given the rash of failures and problems of major corporations such as Enron, Nortel, WorldCom, Adelphia, ImClone, Global Crossings, *et al.*, many of which carefully followed the rules of good governance as recommended by regulators, it is difficult, however, to believe that the regulations made much difference.

On the other hand, there is little doubt that the regulations have had an impact on the structure of boards. The number of outside directors on boards has increased markedly; there has been a rash of separations of the office of chair and chief executive officer; and much more attention is being paid to issues of corporate governance by many more companies. Whether or not the changes in the structure of boards have had any major impact on the decision-making capacities of boards of directors is another question. At any rate, however, the evidence does not support the view that the results of the regulations and rules have had any positive relationship to corporate performance.

BOARDS OF DIRECTORS AND CORPORATE PERFORMANCE: IF THERE IS A CONNECTION, THEN WHY CAN'T WE EXPLAIN IT?

There are several reasons why studies to date have not been able to demonstrate a relationship between various recommendations about board structure and corporate performance. First, the cynics may be correct—none may exist. Second, there may be so many internal and

external contingencies and intervening and moderating factors causing a corporate failure or success, such as a natural disaster or war, that to demonstrate a causal link between board performance and corporate financial performance may simply be impossible. Complex regression analysis equations may be incapable of resolving this issue because they are not capable of handling so many variables. Third, many of the factors involved in board performance may not be able to be expressed in measurable forms. Fourth, there may be time lags between when boards act and when company performance responds that may make any relationship difficult to find.

Another reason for the lack of studies demonstrating a relationship between corporate governance and corporate financial performance may be a political one. Professor Westphal suggests that leaders of the corporate governance reform movement, including “corporate leaders, public policy makers, institutional investors and other corporate stakeholders,” have ignored the findings of academic research (see Chapter 5) and “have already chosen board independence as a rallying cry or unifying theme of the governance reform movement, and to change the message now would diminish the focus, unity and credibility of the movement.”²⁵ Dr. Westphal goes on to state that “[a] focus on independence may also attract more attention to the movement, as it taps into popular suspicions about corporate leaders and concerns about the apparently “excessive” CEO pay and perquisites. A focus on director capabilities may be less effective as a lightning rod to mobilize the governance reform movement.” In addition, Westphal remarks that “[r]egulators seem more concerned about the impressions that their policies will create than about formulating policies grounded in rational principles and empirical evidence.”²⁶ Professor Donald Thain in Canada was equally critical of the empirical foundation of the Toronto Stock Exchange corporate governance guidelines when they were initially enacted in 1994, when he wrote, “The result is recommendations that have no systematic base in fact and stated logic.”²⁷

25. J. D. Westphal, “Second Thoughts On Board Independence: Why Do So Many Demand Board Independence When It Does So Little Good?” *The Corporate Board* 23:136 (September/October 2002): 10.

26. *Ibid.*

27. D. H. Thain, “The TSE Corporate Governance Report: Disappointing” *Business Quarterly* 59:1 (1994): 80.

LACK OF KNOWLEDGE OF BOARD PERFORMANCE

Some (most) of the above explanations may not be particularly compelling, and perhaps a few are overstated. A much more likely reason for the lack of knowledge is that in all the research that has been done, there is almost no analysis of how boards perform as boards. Surely “the human dynamics of boards as social systems where leadership character, individual values, decision-making processes, conflict management, and strategic thinking”²⁸ at play are as important, if not more so, as the structural composition of the board in determining the nature of the governance of the entity. And yet, in all of the research and analysis of the performance of boards that has been done, an explanation of how boards make decisions is missing although this may well be the *most important factor in determining the effectiveness of the governance of an enterprise*.

The major reason this gaping hole in knowledge about boards exists is that there is almost no public knowledge about the manner in which boards operate. No semi-public (in the sense that they have hundreds of shareholders) institutions are more removed from public inspection than are corporate boards. Meetings of every level of government—municipal, state or provincial, federal and international—are open to the public and often televised, and yet meetings of the boards of companies in which people have invested their money are shrouded in secrecy. The few times when shareholders observe the board members of the companies they own are at carefully planned and conducted annual meetings. The only people who actually know how boards operate are directors themselves, and they, of course, can only reflect on the quality of the decision-making process for the boards of which they are members.²⁹

Consequently, boards are extremely difficult to study. As a class they tend to be closed groups, bound by confidentiality, privilege and customs, and are very difficult to access. Few people other than directors have ever attended a board meeting. Corporate directors tend to be fairly homogeneous in terms of gender, race, socio-economic

28. J. Sonnenfeld, “Good Governance and the Misleading Myths of Bad Metrics” *Academy of Management Executive* 18:1 (2004): 112.

29. Various tables in Chapter 3 cite directors’ views on the effectiveness of the boards on which they serve and that of individual directors..

level, *etc.* A board is a relatively small, concentrated and interrelated group of individuals who have a common interest in maintaining their privacy, with linkages and associations not commonly apparent to most laypeople or academics. As a result, gaining access to board meetings to study directors' behaviour is very difficult, and almost all the empirical work on boards of directors has been based on material that can be obtained from outside the boardroom—annual reports, proxy circulars, press releases and court hearings. The “human factors” in governance have been left out.

Table 1.2

<p>Some Directors' Observations on Corporate Governance: the Good, the Cautious and the Disillusioned</p> <p>“The real issue in corporate governance . . . is that 10 percent of the corporate governance is outstanding whereas 90 percent of it is not.” (director)</p> <p>“Good governance leads to good performance.” (chair and CEO of a financial institution)</p> <p>“Good governance contributes to superior corporate performance—there's no doubt in my mind.” (director)</p> <p>“Boards matter all the time. There's no question that better companies have the best boards. In times of crisis, the intensity of activity heightens. Strong companies were built by having strong boards and good management and good strategy.” (director)</p> <p>“Stakeholders are popular normatively but shareholders are the reality.” (director)</p> <p>“Boards consider stakeholders only if it's in their interest to do so.” (director)</p> <p>“Nothing is more important than good corporate governance. It's shareholder value. . . . Stakeholder value is also important. The corporation has a big responsibility to stakeholder value. It's not shareholder value by itself, but includes stakeholder value such as society, communities, etc.,</p>

who produce dividends for shareholders. You have to weigh these things for good corporate governance. It's also timeframe, short term versus long term. There's a tendency to focus on the short term, but we're here for the long term." (director)

"[T]here are no hard and fast rules on corporate governance. . . . It is not an exact science. It's an ability to analyze and decide whether it's the right thing for the people affected. It's not short term, but a weighing. The legal, moral and ethical are there to balance when you're a board member, and ultimately voting. You're always weighing. It's the same in Cabinet, from a governance standpoint. You're weighing. What's the net-net benefit to the country over the longer term? I practised corporate governance all the time . . . every minute of every hour of every day. . . . Very seldom is it win-win. There are tradeoffs and it's a question of degree of win and loss. So corporate governance is judgment and net-net over the longer term." (director)

"It's foolish to think that good governance keeps you out of trouble. You will lessen the likelihood of trouble and maximize performance but with good governance you can still have judgmental errors by the board and errors of management, which tend to be errors of timing rather than errors of product or service. Good governance alone does not protect institutions from making mistakes and legitimate mistakes. It's one of the tools." (director)

"The measurability of governance? It's not measurable. This is an art form. Even some of the very best boards go through bad luck, extraordinarily adverse conditions, which contaminate the data, and you don't know if there was a deeper downside." (director)

"In the correlation between corporate governance and financial performance, what's the causal event? In many cases it's not doing something. For example, the board says 'no'. How do you measure this? What's the negative correlation to a non-event?" (director)

"[C]orporate governance is the most difficult part of business to quantify. Although it has a great effect on the success of the venture, it does not have a measurement like EPS or cash flow. There is nothing in business that is so related to basic human nature as an independent outside board of directors." (CEO)

Continued

“[The] quantitative rigour ignores 80 percent of what matters.” (director)

“The smartest boards can be caught off base to a certain degree, so good governance is not enough.” (director)

“Good governance does not get you there and good governance does not grow a company.” (director)

“Institutional shareholders don't give a ____³⁰ about the stakeholders, yet if I'm CEO of [Company ABC], I have to worry about consumers, creditors, communities, governments. . . . I'm very careful. Institutional shareholders don't give a ____ . They're in it for the short-term hype. Six months and they're out. . . . Let's start to focus on institutions. Where's your corporate governance, you holier than thou ____ ?” (director)

“It's a country club—you bring your friends in, not who is most effective. This exists because the board does not truly acknowledge what its role is and the needs and demands of shareholders are not highest. . . . Rare is the case when people are brought on to the board based on what they can contribute. It's payback for a favour, throwing a bone, a good name, not competence or value.” (director)

“The result is recommendations [by the “Dey Committee”] that have no systematic base in fact and stated logic.” (D. H. Thain, “The TSE Corporate Governance Report: Disappointing” *Business Quarterly* 59:1 (1994): 80.

“This governance stuff has been all blown out of whack.” (controlling shareholder)

“If I hear one more thing about corporate governance, I think I'm going to puke.” (chair)

And yet, gaining an understanding of the internal workings of boards, which Leighton and Thain refer to as “the black box of corporate governance,”³¹ through observing boards at work in real

30. Profanity and expletives exist within some of the quotations. Although only a small minority of respondents used foul language, by excising the existence of swear words, the integrity and meaning of some of the commentary and trustworthiness of the data might be affected. The decision was made, therefore, not to tamper with the quotations, other than by succinct editing.

31. Leighton and Thain, *Making Boards Work: What Directors Must Do to Make Canadian Boards Effective*: xviii.

time is probably the only way of obtaining a truly comprehensive understanding of the role the board plays in determining the corporation's performance. Almost nothing is known about how directors relate to one another as a group, how the board interacts with management or how decisions actually get made, both inside and outside of the boardroom. And yet it is the work of the board and the way that it is done that is the most important factor in determining the relationship between corporate governance and corporate performance. The current reality of corporate governance knowledge is that the "what" and "how" of a board of directors—its work and its processes—are still unknown.

It is interesting that the inability to find a positive relationship between most of the recommendations for changes in the structure of boards and better corporate performance has not in any way lessened the general view of directors, chief executive officers, politicians and regulators that one exists. In fact, only one respondent, of the almost 200 interviewed for this book, was of the view that better boards *do not* make for better companies. This prominent director remarked that "boards negatively impact financial performance, as currently constituted" and were "grotesque orgies of self-protection." Overwhelmingly, however, directors persist in believing that there is a persuasive relationship between corporate governance and corporate performance, and yet no one knows what it is.

And their intuition and experiences are probably quite correct. It may well turn out that the much sought after "missing link" between corporate governance and corporate performance will be found in "board process." It may well be that when more is learned about board process—the appropriate interaction of boards for successful decision-making—that directors, nomination committee chairs, institutional and private investors, regulators and lawmakers will be able to make the decisions and regulations that will lead to more effective corporate governance performance, which, in turn, will lead to better corporate performance.

